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SUBJECT: SCENESETTER FOR CODEL CORKER VISIT TO KYIV

Summary

¶1. (SBU) Your November 8-10 visit to Ukraine comes during an unfolding domestic economic crisis and an ongoing struggle between President Yushchenko and Prime Minister Tymoshenko over whether to hold snap parliamentary elections. Yushchenko on October 8 dissolved Ukraine's parliament (the Rada) and asked for new elections. Delays in passing required election-related legislation mean the date of the election is likely to slip into early 2009. Tymoshenko has rejected the necessity for new elections, citing the unfolding economic crisis as requiring continuity and collective action. The IMF has announced that it would support Ukraine with a \$16.5 billion IMF package -- one of the largest in IMF history -- if Ukraine adopts a series of reform measures. At the time of this writing, the Rada is debating a bill aimed at meeting IMF requirements.

¶2. (SBU) Ukraine's relationship with Russia has remained tense following the Russia-Georgia conflict. President Yushchenko strongly supported President Saakashvili and issued decrees that seek to more closely regulate Russia's Crimea-based Black Sea Fleet (BSF). Ongoing Ukrainian political wrangling has not benefited President Yushchenko's aspiration to receive a NATO Membership Action Plan (MAP) at the NATO Foreign Ministers meeting in December. End Summary.

Major Themes and Talking Points

¶3. (SBU) Your visit provides an opportunity to engage with key decision makers and underline our bilateral policy objectives. We suggest the following main themes for your meetings:

- Financial: the President, Prime Minister, and Rada need to unite to deal with Ukraine's financial crisis. Providing examples of bipartisan solutions recently developed in the United States would help underline this point.
- Energy: Ukraine needs to increase transparency in the energy sector, increasing competition, removing unnecessary middle-men (such as RosUkrEnergo), and establishing an open contracting system.
- NATO: decisions regarding the pursuit of MAP and NATO membership are up to Ukraine -- the United States will support Ukraine's decision. NATO does not drag countries into the Alliance against their will.

Orange Coalition Falters

¶4. (SBU) Orange Revolution allies Viktor Yushchenko and Yuliya Tymoshenko united forces following an unexpectedly strong showing by Tymoshenko's political bloc in the September 2007 pre-term parliamentary elections. They formed a coalition and established a government in late 2007 with

Tymoshenko as Prime Minister, recreating their post-Orange Revolution alliance. Many hoped that they would work together better than they did in 2005, when Yushchenko dismissed Tymoshenko after seven months of infighting. Following an initial phase of cooperation, we again witnessed a string of mutual recriminations, including a charge by the Presidential Secretariat last August that Tymoshenko was guilty of high treason. The allegation was that in return for securing lower energy prices from Russia, Tymoshenko had agreed to go slowly on NATO/MAP and keep open the option of Russia's Black Sea Fleet to remain in Crimea beyond the 2017 withdrawal deadline. Tymoshenko has denied all charges, but the Secretariat's actions clouded the prospects for future accommodation between the President and PM. The split was finalized on October 8, when Yushchenko dissolved the Rada and called pre-term elections.

Two Headstrong Leaders

15. (SBU) President Yushchenko has a reputation as a visionary. Even his critics concede that his commitment to seeing Ukraine join NATO and the European Union is sincere and unwavering. He has been the driving force behind Ukraine's request for a MAP and tireless in making the case both at home and abroad. In Yushchenko's view, NATO membership is the only thing that can guarantee Ukrainian sovereignty and territorial integrity for the long run. He has stated that recent events in Georgia reinforce the need for collective security arrangements for Ukraine. Yushchenko has a close relationship with Georgian President Saakashvili, and is the godfather to Saakashvili's son. Significantly

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recovered from his 2004 dioxin poisoning, Yushchenko's scarred face continues to clear up and his health appears to have improved.

16. (SBU) Returning to political center stage after two years in opposition with her trademark braided hairstyle intact, PM Tymoshenko hit the ground running after her December 2007 confirmation as Prime Minister in a restored orange coalition. She got a budget passed in eight days, completed her government program for the upcoming year, and made some progress in fulfilling campaign promises, such as to return lost savings from the defunct Soviet-era state savings bank. Tymoshenko joined Yushchenko and Rada Speaker Yatsenyuk in signing a letter requesting a NATO Membership Action Plan (MAP) and spoke in favor of MAP during private meetings with the NATO SYG and North Atlantic Council during their June visit to Kyiv. In recognition of the public's ambivalence about NATO membership for Ukraine, Tymoshenko has avoided taking a public stance. She was conspicuously involved in the response to summer floods in western Ukraine, but initially remained silent when the conflict in Georgia erupted. Tymoshenko has since made statements in support of Georgia's territorial integrity and sovereignty.

Elections Called, IMF Package Delayed

17. (SBU) On October 8, Yushchenko announced a decree disbanding the Rada and calling for pre-term parliamentary elections. In his address, Yushchenko once again blamed the Tymoshenko Bloc (BYuT) for the collapse of the coalition, pointing to BYuT's votes with Regions in the current Rada session. Without naming her, Yushchenko cast the blame on Tymoshenko, saying that he was "absolutely certain" that the democratic coalition was destroyed because of the "personal ambition of one person."

18. (SBU) PM Tymoshenko opposed the decision to call pre-term elections, citing the unfolding domestic economic crisis as requiring political continuity and stability. The call for elections, which require passage of laws both on administering and funding the vote, has become intertwined

with the financial legislative package required for the \$16.5 billion IMF support program. The inability to consider the issues (and legislation packages) independently stalled progress on both fronts. On October 29 the Rada passed a first reading of the financial package (a second reading/vote is still required).

Economic Challenges

¶9. (SBU) Ukraine's current financial crisis stems from a sharp decrease in international credit due to the global financial crisis and Ukraine's precarious balance of payments situation. Ukraine will have to finance \$50 to \$60 billion in foreign commitments due in 2009. Ukraine's banking sector, which grew rapidly in recent years thanks to aggressive foreign borrowing, is of chief concern. The main issue is the ability of banks to roll over short term external debt (currently totaling approximately \$13 billion) which will come due in next few months. The current account deficit has ballooned in recent years and could exceed \$15-\$20 billion next year. Ukraine's foreign exchange reserves, which totaled \$37 billion at the start of the crisis, will not cover all of the country's expected financing needs. The Ukrainian currency, the hryvnia, continues to fall and trade outside of the official exchange rate band.

Challenges to the Real Economy

¶10. (SBU) A downturn in global demand for steel and chemicals (Ukraine's chief exports), along with rising prices expected for gas imports and a downturn in credit conditions has led analysts to revise downward growth forecasts radically, with most now expecting zero or even negative real GDP growth in 2009, after about 6 percent this year. In addition to a failing banking sector and an already apparent sharp contraction in the steel industry, we expect sharp corrections in Ukraine's overheated construction and real estate sectors, an overall decline in investment, increased capital flight and rising energy prices and inflation.

Policy Responses to Financial Crisis

¶11. (SBU) The National Bank of Ukraine (NBU), pressed to stop a run on deposits in commercial banks, sharply tightened capital controls on October 13. The measures effectively

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prevent Ukraine's banking system, which has relied heavily on foreign borrowing to fuel its breakneck growth in recent years, from expanding any further in the short term. The action comes after an estimated \$3 billion, or 4% of total deposits, were withdrawn from the banking system in mid to late October. The October 13 measures are the first taken by the NBU to preempt capital flight and stabilize the country's financial system. Both the President and Prime Minister have submitted stabilization packages to the parliament. They are aimed at securing IMF support and focus on recapitalizing the banking sector and introducing stricter fiscal discipline, as liberal public spending and salary/pension policies have been a main cause of Ukraine's galloping inflation.

Ukraine and Energy

¶12. (SBU) The geopolitics and economics of energy continue to play a central role in Ukraine. Energy consumption per capita remains the highest in the world, and the energy infrastructure is decaying. Ukraine remains heavily dependent on gas and oil imports from Russia and Central Asia, and is the main transit country for Russian gas shipments to central and western Europe. Most Ukrainian policymakers agree that Ukraine must diversify its sources of

energy and move towards a market-based energy relationship with Russia, but Kyiv has yet to develop a long-term strategy to achieve these goals.

¶13. (SBU) The USG has encouraged Ukraine to open its energy market to more foreign investment. Few Ukrainian energy companies have the technical and financial resources to bring domestic production up to potential. Recent moves by the GOU to undercut its first-ever Production Sharing Agreement (PSA), signed with the U.S. company Vanco in 2007, are raising doubts about the GOU's sincerity in attracting foreign investment to develop domestic energy resources. There are some bright spots, however. Within the framework of the USG-supported Nuclear Fuels Qualification Project, Westinghouse has signed a contract to initially supply three Ukrainian reactors with fuel starting in 2011. This will help Ukraine diversify its sources of fuel for its nuclear power plants, all of which currently get their fuel from Russia. Russia also currently takes back spent nuclear fuel, but New Jersey-based Holtec has a contract to build a facility to store spent fuel within the country.

NATO/MAP

¶14. (SBU) The NATO Bucharest Summit did not grant a Membership Action Plan (MAP) to Ukraine. However, the Alliance declared it sees Ukraine as a member in the future, urged intensified dialogue, and set a December 2008 date for an initial re-evaluation by Foreign Ministers. A NATO Public Information Campaign targeted at providing information on MAP/Membership issues was recently launched by the government. Public opinion remains highly skeptical of the prospect of NATO membership, with less than 25 percent in favor and more than 50 percent opposed. The GOU information campaign remains under-funded at \$2 million a year, but we understand that additional resources are being committed in parallel with the government's effort. One example is notable -- a series of pro-NATO commercials were shown during half-time of the recent European Soccer Championship. The spots highlighted the dates of NATO and EU membership of the contestants (when applicable), portraying NATO as a grouping of democratic, progressive countries.

¶15. (SBU) Following Russia's actions in Georgia, Ukraine on August 18 requested emergency consultations with NATO allies to discuss threats to Ukraine's national security arising from that crisis. FM Volodymyr Ohryzko has stated that events in Georgia argue strongly for even closer integration of Ukraine into the Euroatlantic community and for NATO membership. Yushchenko made a high-profile visit to Tbilisi on August 12 and, on the same day, signed two decrees meant to 1) regulate border crossing for Russia's Black Sea Fleet (BSF) personnel, ships, and planes, and 2) require GOU permission for future BSF deployments. Yushchenko's move triggered a sharp exchange between Kyiv and Moscow. The MFA recently reconfirmed Ukraine's intention to hold Russia to the 2017 BSF withdrawal date agreed to in the 1997 basing agreement. The basing agreement requires either signatory to inform the other at least one year prior to the 2017 withdrawal deadline of its intention to enforce the agreement -- otherwise an automatic 5-year extension applies.

¶16. (SBU) Leading politicians from other parties have spoken of taking a less confrontational approach to the situation in Georgia. PM Tymoshenko has spoken of supporting the

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territorial integrity of Georgia, but warned of exacerbating regional tensions. She opposed Yushchenko's decrees to regulate the Black Sea Fleet as unenforceable and liable to further increase tensions with Russia. The Lytvyn Bloc, which advocates Ukrainian neutrality, released a statement urging Ukraine to give up its intentions to join NATO any time soon. The Party of Regions, headed by former PM Yanukovich was critical of Yushchenko's support for

Saakashvili and Ukraine's provision of arms to Georgia.
Yanukovych spoke in favor of recognizing the "independence"
of South Ossetia and Abkhazia.

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